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No. 98-1639

In the Supreme Court of the United States

SUSAN TAYLOR MARTIN, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the payment received by petitioner from a third party for the sale of her claims against a bankruptcy estate is exempt from tax as a transfer of "an asset from the estate to the debtor" under Section 1398(f)(2) of the Internal Revenue Code, 26 U.S.C. 1398(f)(2).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-14) is reported at 159 F.3d 932. The opinion of the district court (Pet. App. 15-33) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on November 12, 1998. The petition for rehearing was denied on January 13, 1999 (Pet. App. 36). The petition for a writ of certiorari was filed on April 12, 1999. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner married Ken Martin 1958. They lived in Louisiana prior to their legal separation and divorce

in 1991, and all of the property that they possessed while married was community property (Pet. App. 2).

On February 19, 1991, Ken Martin filed a petition for relief under Chapter 7 of the Bankruptcy Code. Petitioner did not join in the petition. Since her husband's bankruptcy petition was filed prior to any legal partition of the community property, the community property became part of her husband's bankruptcy estate under 11 U.S.C. 541(a). To protect her interest in the community property, petitioner filed a proof of claim in the bankruptcy case in which she asserted an "undivided 1/2 interest in debtor's community" (Pet. App. 2-3 n.3). In an amended proof of claim, she further asserted "claims for fraud, bad faith management of the community, breach of [the] debtor's fiduciary duty, and any and all other delictual, contractual and quasi-contractual claims" (*ibid.*).

One valuable asset of the community estate was a gas purchase contract held by Martin Interstate Gas Company, a company formed and wholly owned by Ken Martin (Pet. App. 3 n.4). The contract required Louisiana Interstate Gas Company to purchase large quantities of natural gas at a specified price that was substantially higher than the prevailing market price (*ibid.*). Tenneco, Inc., which had guaranteed the buyer's performance under the gas purchase contract (*ibid.*), recognized that it would have substantial liability under the contract. It therefore sought to acquire the interests of all parties asserting rights thereunder (*id.* at 18). Those parties included petitioner and the trustee of her husband's bankruptcy estate (*ibid.*).

On July 1, 1993, Tenneco entered into an agreement with petitioner under which it paid her $5.75 million in exchange for her release of her claims under the gas purchase contract and her conveyance to Tenneco of all

of her claims against her husband's bankruptcy estate (Pet. App. 18-19). On July 2, 1993, Tenneco entered into an agreement with the trustee of her husband's bankruptcy estate under which the trustee was paid $7 million for an option to purchase the estate's rights under the gas purchase contract (*id.* at 20).

On July 9, 1993, the trustee of the bankruptcy estate commenced an adversary proceeding in which it claimed that the $5.75 million that Tenneco had paid to petitioner was property of the estate (Pet. App. 20). Petitioner argued that she could not and did not sell to Tenneco any assets belonging to her husband's bankruptcy estate. The bankruptcy court agreed, holding that petitioner sold to Tenneco only her personal interest as a claimant against the bankruptcy estate (*ibid.*).

On March 3, 1994, Tenneco and the trustee of her husband's bankruptcy estate amended the July 2, 1993, agreement to provide a release of all outstanding claims by each party to the various lawsuits concerning the gas purchase contract and to effect a distribution of all of the assets in the bankruptcy estate (Pet. App. 21). No distribution was ever made from the estate to Tenneco in satisfaction of the claims that it had acquired from petitioner (*id.* at 21-22).

2. The trustee of the bankruptcy estate reported the $7 million payment from Tenneco on the estate's federal income tax return for its fiscal year 1992 (Pet. App. 20, 22). Although petitioner disclosed the $5.75 million payment from Tenneco on her federal income tax return for the year 1993, she took the position that the payment was not subject to tax. The Internal Revenue Service audited her return and determined that the payment constituted taxable income. Petitioner paid the resulting taxes and interest and brought this refund suit in district court (*ibid.*). She contended that the

payment she received from Tenneco was excluded from tax under Section 1398(f)(2) of the Internal Revenue Code on the theory that it constituted a transfer "of an asset from the estate to the debtor" (26 U.S.C. 1398(f)(2)).[1]

The district court granted the government's motion for summary judgment (Pet. App. 34-35). Noting that all income from any source is presumptively taxable, the court concluded that petitioner had failed to demonstrate that the $5.75 million payment from Tenneco falls within any specific exclusion from tax under the Internal Revenue Code (*id.* at 23). The court ruled, in particular, that Section 1398(f)(2) of the Internal Revenue Code does not apply to this case because petitioner was not a "debtor" to whom that exclusion applies. Instead, petitioner "was a 'nonfiling spouse,' which does not equate to a bankruptcy 'debtor'" (*id.* at 25). Moreover, "there was no transfer of an 'asset,' but rather the transaction was a sale of [petitioner's] claim against the [bankruptcy] estate" and petitioner "did not receive the $5.75 million from the 'estate' but from 'Tenneco'" (*id.* at 26). Because this

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[1] Petitioner contended in the alternative that, under the rationale of *United States* v. *Davis*, 370 U.S. 65 (1962), the payment from Tenneco should be viewed as if it were a taxable sale of marital property by her husband's bankruptcy estate to petitioner followed by a sale of that property by petitioner to Tenneco. The district court and the court of appeals rejected that contention (Pet. App. 13, 31-33), and petitioner has not raised that claim in her petition in this case.

Petitioner also argued in the district court that the payment was excluded from her income under Section 1041 of the Internal Revenue Code as a transfer of property between spouses incident to divorce (Pet. App. 24, 27-31). She waived that contention in the court of appeals (*id.* at 11), however, and has not renewed it here.

case involves the sale of an asset by a non-debtor to a third-party, and does not involve the transfer of an asset from the estate to the debtor, the exclusion from tax provided by Section 1398(f)(2) is "inapplicable here" (*id.* at 25).

3. The court of appeals affirmed (Pet. App. 1-14). The court concluded that Section 1398(f)(2) "is inapplicable to the facts of this case" because petitioner "never received a transfer of an asset from the Estate on termination of the Estate" (*id.* at 8). The court held that the "origin of the claim doctrine" does not apply to recharacterize the $5.75 million payment from Tenneco to petitioner as a payment in satisfaction of petitioner's marital claims against the bankruptcy estate (*id.* at 9-11). The court explained that petitioner's claims against the bankruptcy estate "were not settled; * * * th[e] [payment from Tenneco] did not extinguish her underlying claims * * * ; rather, it expressly transferred her claims to Tenneco" (*id.* at 10).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. In a liquidation or reorganization under the Bankruptcy Code, the bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case" (11 U.S.C. 541(a)(1)) as well as the "[p]roceeds * * * or profits of or from property of the estate" (11 U.S.C. 541(a)(6)). See *In re Graham*, 726 F.2d 1268 (8th Cir. 1984). The bankruptcy estate formed by the commencement of a bankruptcy case is a separate taxable entity; it is directly liable for any taxes owed with respect to the items of income that it

receives. 26 U.S.C. 1398. See *In re Kochell*, 804 F.2d 84, 87 (7th Cir. 1986).

Because the bankruptcy estate is itself to pay the tax owed on the income it receives, Section 1398(f)(2) of the Internal Revenue Code provides that, on "termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor" is to be treated as a tax-free exchange. 26 U.S.C. 1398(f)(2). See *In re Terjen*, 154 B.R. 456, 458 (Bankr. E.D. Va. 1993), aff'd, 30 F.3d 131 (4th Cir. 1994). This statute thereby avoids a double tax on the items of income already subjected to tax in the hands of the bankruptcy estate.

As the courts below correctly concluded (Pet. App. 8-10, 25-26), Section 1398(f)(2) does not apply to this case. That Section applies only to transfers "from the estate to the debtor." Petitioner, who neither filed nor joined in the bankruptcy petition, plainly was not a "debtor" in the bankruptcy case. See 11 U.S.C. 101(13); *In re Kastner*, 197 B.R. 620, 623-624 (Bankr. E.D. La. 1996). Moreover, as the court of appeals observed, petitioner "never received a transfer of an asset from the Estate on [the] termination of the Estate" (Pet. App. 8). Instead, she received a payment of $5.75 million from Tenneco almost one year prior to the termination of Ken's bankruptcy estate (*id.* at 11).[2]

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[2] The present case involves a factually unique situation—the purchase by an unrelated party of the nonfiling spouse's claims against a bankruptcy estate. Notwithstanding petitioner's suggestion that the number of nonfiling spouses whose interest in community property is transferred to their spouses' bankruptcy estate is "probably substantial, perhaps in the thousands" (Pet. 11), we are unaware of any similar pending cases. The specific issue presented in this case is unlikely to recur with any frequency, if at all.

2. a. Petitioner contends (Pet. 12-17) that, under the "origin of the claim doctrine," the payment that she received from Tenneco should be recharacterized as a payment from her husband's bankruptcy estate. Under the "origin of the claim doctrine," amounts received in settlement of a claim are treated for tax purposes as having the same character as the claim itself. See, *e.g.*, *Helvering* v. *Safe Deposit Co.*, 316 U.S. 56 (1942); *Lyeth* v. *Hoey*, 305 U.S. 188 (1938); *Early* v. *Commissioner*, 445 F.2d 166 (5th Cir.), cert. denied, 404 U.S. 855 (1971); *Raytheon Production Corp.* v. *Commissioner*, 144 F.2d 110, 113 (1st Cir.), cert. denied, 323 U.S. 779 (1944). Petitioner errs, however, in asserting (Pet. 11) that the payment she received from Tenneco released her husband's bankruptcy estate from petitioner's marital claims and should therefore be treated as a nontaxable distribution from the bankruptcy estate to petitioner.

The court of appeals correctly rejected petitioner's attempted application of the "origin of the claim doctrine" to this case. As the court explained (Pet. App. 10):

> [Petitioner's] claims were not settled; she sold her claims against Ken's estate to Tenneco for a $5.75 million payment. This payment did not operate to extinguish her underlying claims against the Estate; rather, it expressly transferred her claims to Tenneco. Consequently, regardless of whether [petitioner] might have thought subjectively that this payment was in settlement of her claims—in lieu of a tax-free Estate distribution—the fact is inescapable that the $5.75 million payment is the proceeds of the sale of her unextinguished claims.

The agreement between petitioner and Tenneco did not settle petitioner's marital claims against the bank-

ruptcy estate; it merely transferred those claims to Tenneco. The payment from Tenneco did not, in form or substance, constitute a transfer from the estate to petitioner. Moreover, even if it had, petitioner is not the "debtor" to whom tax-free distributions may be made under Section 1398(f)(2). She was instead a claimant against the bankruptcy estate. The transfer of assets from a bankruptcy estate to a claimant against the estate does not qualify for tax-free treatment under the plain text of Section 1398(f)(2).

b. Petitioner errs in contending (Pet. 12-16) that the decision in this case narrows the "origin of the claim doctrine" and thereby conflicts with *Lyeth* v. *Hoey*, *supra*.[3] The *Lyeth* case involved an heir who contested a will that left him a small legacy while leaving the residue of the estate to the founder of the Christian Science religion. The heir claimed that the will was invalid due to lack of capacity and undue influence. Under the settlement of that will contest, the heir received $140,000 from the residue of the estate. The Internal Revenue Service treated the settlement payment as income to the heir in the year it was received. This Court held, however, that the property had been acquired "by bequest, devise, or inheritance" and was therefore not subject to the federal income tax. 305

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[3] Petitioner also erroneously contends (Pet. 12-14) that the decision in this case conflicts with *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580 (1970), *Woodward* v. *Commissioner*, 397 U.S. 572 (1970), and *United States* v. *Gilmore*, 372 U.S. 39 (1963). Those cases involve the deductibility of litigation costs in the context of divorce and corporate restructuring transactions and are plainly inapposite to the facts of this case.

U.S. at 195-197. The Court explained that (*id.* at 195-196):

> [Lyeth] was concededly an heir of his grandmother under the Massachusetts statute. It was by virtue of that heirship that he opposed probate of her alleged will which constituted an obstacle to the enforcement of his right. * * *
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> * * * * *
>
> There is no question that [Lyeth] obtained that portion [of the decedent's estate], upon the value of which he is sought to be taxed, because of his standing as an heir and of his claim in that capacity.

The facts of *Lyeth* are, of course, quite different from those of the present case. Moreover, the reasoning of *Lyeth* contradicts petitioner's position in this case. In entering into the agreement with petitioner, Tenneco was not acting on behalf of her husband's bankruptcy estate and did not seek to satisfy petitioner's marital claims. Instead, as the record demonstrates (Pet. App. 2-3, 18-19), Tenneco's concern was to limit its potential liability under the gas purchase contract. Under the agreement with petitioner, Tenneco *acquired* her claims against the bankruptcy estate; it did not *extinguish* those claims. Under the reasoning of *Lyeth*, since payments made to petitioner pursuant to the gas purchase contract would unquestionably have been taxable, the amounts paid to petitioner in settlement of her claims under that contract should also have the same character and are therefore plainly subject to tax. See *Lyeth* v. *Hoey*, 305 U.S. at 195-197.

Petitioner errs in contending (Pet. 14-16) that the decision in this case conflicts with the holdings of other circuits. Those decisions, like *Lyeth*, simply hold that

the nature or character of amounts received in settlement of a claim turns on the nature of the claim settled. See, *e.g.*, *Alexander* v. *Internal Revenue Service*, 72 F.3d 938, 942-944 (1st Cir. 1995); *Parker* v. *United States*, 573 F.2d 42, 46-48 (Ct. Cl.), cert. denied, 439 U.S. 1046 (1978); *Early* v. *Commissioner*, 445 F.2d 166, 170 (5th Cir. 1971); *Turzillo* v. *Commissioner*, 346 F.2d 884, 887-888 (6th Cir. 1965); *Commissioner* v. *Murdoch*, 318 F.2d 414, 426-427 (3d Cir.), cert. denied, 375 U.S. 879 (1963); *Victor E. Gidwitz Family Trust* v. *Commissioner*, 61 T.C. 664, 673 (1974). None of those decisions holds that the purchase by an unrelated third party of a taxpayer's right to sue a debtor in a bankruptcy case is to be characterized as a payment from the bankruptcy estate to the "debtor" under Section 1398(f)(2) of the Internal Revenue Code.

3. Petitioner errs in contending (Pet. 18-21) that a failure to treat her as a "debtor" for purposes of Section 1398(f)(2) of the Internal Revenue Code would deny her equal protection of the laws. A different tax treatment of debtors and claimants against the bankruptcy estate is constitutionally permissible.

The guarantee of equal protection under the Due Process Clause of the Fifth Amendment is "essentially a direction that all persons similarly situated should be treated alike." *City of Cleburne* v. *Cleburne Living Center*, 473 U.S. 432, 439 (1985) (quoting *Plyler* v. *Doe*, 457 U.S. 202, 216 (1982)). See also *Schlesinger* v. *Ballard*, 419 U.S. 498, 500 n.3, 507 (1975). A "debtor" and a person who possesses a claim against the bankruptcy estate are plainly not "similarly situated." As a nonfiling spouse who had an interest in the community property transferred to the bankruptcy estate pursuant to 11 U.S.C. 541(a)(2), petitioner was entitled to and did file a claim against the estate. 11 U.S.C. 101(10), 501.

By contrast, her husband, who was the "debtor" in the bankruptcy case, retained no interest in the non-exempt community property transferred to the bankruptcy estate and was entitled only to any excess property that might remain after satisfaction of all claims. 5 *Collier on Bankruptcy* ¶ 541.04, at 541-12 (rev. 15th ed. 1999). Because a bankruptcy estate is a separate taxable entity that directly recognizes and pays tax upon the items of income to which the estate is entitled (see page 5, *supra*), the bankruptcy estate involved in this case was required to and did pay federal income taxes on the $7 million settlement payment that it received from Tenneco (see page 3, *supra*). After that tax was paid, if any property had remained to be distributed to the "debtor," Section 1398(f)(2) would operate to prevent a double tax being imposed on that amount received by the "debtor." By contrast, since petitioner was not the "debtor," the bankruptcy estate paid no tax on the settlement she made with Tenneco. As a claimant against the bankruptcy estate, she was thus not similarly situated with the "debtor" in the tax treatment of these transactions. The different treatment of her settlement merely reflects—and equalizes—these differences in the tax treatment of "debtors" and non-debtors.

Section 1398(f)(2) is thus designed to achieve, not undermine, equal taxation of similar items of income. By recognizing these differences in the tax treatment of debtors and non-debtors, Section 1398(f)(2) does not deny equal protection of the laws. See *Schlesinger* v. *Ballard*, 419 U.S. at 500 n.3, 507; *Richard* v. *Hinson*, 70 F.3d 415, 417 (5th Cir. 1995), cert. denied, 518 U.S. 1004 (1996). There is no conflict among the circuits nor other reason to warrant review of the decision in this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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